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UNCLAS SECTION 01 OF 02 ULAANBAATAR 000287

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TREASURY FOR TTYANG; PASS IMF, WORLD BANK USED
MANILA AND LONDON PASS TO ADB, EBRD USED
BANGKOK FOR USAID RDMA

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SUBJECT: IMF: HIGH INFLATION THREATENS MONGOLIA'S ECONOMIC PROGRESS

REF: A) ULAANBAATAR 0116, B) ULAANBAATAR 0276, C) ULAANBAATAR 0686,

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¶1. (SBU) SUMMARY: According to the IMF's 2008 Article IV Consultation report, Mongolia's recent economic performance has been impressive, mainly due to high mineral prices, but inflation threatens stability and continued growth. GDP growth has averaged more than 9% per annum since 2004, and per capita income has more than doubled. The budget has recorded three consecutive years of surplus, the public debt burden has been cut sharply, the external current account is in surplus, and international reserves have reached record levels. The IMF recommends a tightening of both fiscal and monetary policy to curb inflation and establishing a transparent, stable and investment-friendly mining regime to exploit the country's vast reserves. END SUMMARY.

¶2. (SBU) According to the IMF, high mineral prices have re-energized plans to exploit very large untapped deposits of copper, gold, coal, uranium and other minerals. If mining at the Oyu Tolgoi copper and gold deposit begins in 2011, as scheduled, the IMF predicts real GDP growth will be around 7-9% in 2008-10, and will rise to 12-14% in 2011-12. Other large mining projects, not included in this prediction, give significant upside potential to this outlook. However, the IMF warns that in order to unlock this wealth, the GOM will need to take disciplined fiscal and monetary policy action to combat inflation and to create a stable macroeconomic environment. It will be equally important to have transparent, stable and internationally competitive investment regimes. The Parliamentary elections in June 2008 are adding to the political difficulty of this task.

FISCAL POLICY RECOMMENDATIONS

¶3. (U) The IMF stressed that fiscal policy should be tightened to curb inflation and they welcomed the GOM's decision not to proceed with additional spending this year. They believe the GOM should aim at maintaining a modest fiscal surplus in 2008, instead of the budgeted GDP deficit. The GOM can achieve this by containing the wage bill, preventing low-priority capital spending, and consolidating targeted welfare programs. With the volatility inherent with a large mining sector, the IMF recommended that the GOM reduce the non-mineral deficit over the medium term, with a separate limit on the expenditure-to-GDP ratio and make few exceptions for non-concessionary loans, and only once inflation is under control.

MONETARY POLICY SUGGESTIONS

¶4. (U) The IMF recommended that Mongolia's monetary policy be directed at reducing inflation and suggested that the BOM consider a further moderate interest rate increase to reduce the likelihood of a more abrupt tightening in the future. The IMF concluded that the real exchange rate is currently somewhat undervalued, and that greater exchange rate flexibility would enhance the economy's flexibility and reduce inflation.

BANKING SUPERVISION

¶5. (U) The IMF found the BOM's framework for banking supervision to be generally well developed, but said rapid growth of the banking sector could hinder the BOM's ability to spot emerging problems. Going forward, it said, the BOM should continue to upgrade the supervisory framework by monitoring large exposures and improving

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the supervision of liquidity and operational risks of banks. The IMF also encouraged the authorities to monitor the size and nature of private capital flows, while maintaining an open capital account regime.

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